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Your Ref:

Fortescue
The New Force in Iron Ore

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11 March 2019

Dear Ms Cuevas

Review of the Western Australian Rail Access Regime

The 'Draft Decision Paper' covering the '*Review of the Western Australian Rail Access Regime*' sought feedback on how the recommendations put forward could be improved or advice concerning any unintended consequences. Feedback was also sought on the reasonableness of the value estimates contained in the preliminary cost benefit analysis. Fortescue Metals Group Limited (Fortescue) wishes to respond to these requests on behalf of The Pilbara Infrastructure Pty Ltd (TPI).

1. EXECUTIVE SUMMARY

The costs benefit analysis used to justify the proposed changes to the pricing mechanisms was based upon wholly unrealistic assumptions. If the same analysis, as was undertaken by Synergies Economic Consulting (Synergies) in their report – '*Cost Benefit Analysis of a new pricing mechanism for rail access in WA*' – is repeated, using more realistic assumptions, the calculated net present value (NPV) falls from a net **benefit of $24.4m** to a net **cost of $17.6m**. The main element in the proposed changes to the pricing mechanisms was a change in the asset valuation methodology from a Gross Replacement Value (GRV) to a Depreciated Optimised Replacement Cost (DORC) based system. This will impose considerable regulatory compliance costs on railway owners, which Fortescue estimated at approximately $17.7m (for railway owners collectively), for negligible benefits (mostly to hypothetical resource project developers requiring rail access) of only about $0.1m.

The analysis within the Draft Decision Paper of the costs and benefits of both the GRV and DORC methodologies is simply not applicable to the 'Pilbara Railways' (being the railways owned and operated by TPI and Roy Hill Infrastructure Pty Ltd) covered by the WA Rail Access Regime, because **they are not**:

- **monopoly assets** (as traditionally defined – since there are two railways servicing what is essentially the same market and they are not uneconomic to duplicate); or
- **poorly maintained** such that any calculated ceiling price inadequately reflects the economic condition of the asset and any floor price does not capture real operating and maintenance costs; or

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- assets where a potential access seeker will suffer unduly from **information asymmetry**, because they are both heavy haul railways which of necessity means that potential access seekers (seeking to run above rail operations upon them) require a level of technical knowledge and expertise that runs contrary to the hypothesised access seeker requiring information to assist in commercial negotiations; or
- **formerly publicly owned infrastructure** assets that were transferred to private ownership with access obligations that reflect the community's former ownership; they are privately owned assets that the owners use to provide services to themselves but come with access obligations that were agreed to as part of gaining permission to build them; or
- **interstate connected assets** such that there would be a requirement for consistency across regimes.

It is inappropriate to utilise the Independent Pricing and Regulatory Tribunal of New South Wales (IPART) report into 'Aspects of the NSW Rail Access Regime' to justify the imposition of the DORC valuation methodology on the Pilbara Railways. IPART stated in their 28 April 1999 Final Report that:

> "*The appropriate asset valuation methodology depends on a number of factors including the objectives for which asset valuations are sought. What may be an appropriate methodology for RAC* (Rail Asset Corporation of NSW) *may be unsuitable for other industries.*" (page ii)
>
> "*IPART is generally of the view that DORC is **not** the 'most reasonable' valuation methodology for setting a maximum allowable revenue of a utility.*" (page 39)

The claim made in the Draft Decision Paper that "*IPART recommended DORC as the most reasonable valuation methodology for setting a maximum allowable revenue of a utility*" (page 11) is not only completely at variance with what IPART actually said (see quote above), but misrepresents IPART's view that whilst DORC was suitable given the specifics of the RAC assets, it did not have wider application.

The Pilbara Railways were put under the Regime through their respective State Agreements (*Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement Act 2004* and *Railway (Roy Hill Infrastructure Pty Ltd) Agreement Act 2010*). In the case of the TPI railway there was initially a choice between putting the railway under the National Access Regime effectively through a Part IIIA undertaking or putting it under the Western Australian *Railway (Access) Act 1998* (Act). During the negotiations with the State, TPI agreed to putting its railway under the Act, precisely because it involved what was perceived to be light handed regulation that would enable third party access to any surplus rail capacity without imposing undue costs upon the railway owner in terms of regime compliance obligations. The proposed changes will result in heavier handed regulation and entail significant additional costs. This represents a violation of the implicit understanding underlying the TPI railway being under the Regime and an entirely inappropriate manifestation of **sovereign risk.**

There are two other heavy haul rail networks operating in the Pilbara (owned by BHP Billiton Iron Ore and Rio Tinto Iron Ore) and those rail networks are not subject to the Regime. To the extent that the proposed changes to the Regime increase the costs associated with the railways for Fortescue and Roy Hill, it puts Fortescue and Roy Hill at a **competitive disadvantage** in terms of costs associated with iron ore supply. That competitive disadvantage is compounded by requirements to make public commercially sensitive information that would enable competitors to

benchmark their operations whilst not being required to make the same information available; and by having to deal with frivolous and vexatious access applications (including ambit claims) when competitors don't face having to incur the same unnecessary costs.

The changes proposed under the draft recommendations that relate to the pricing mechanisms (recommendations **1A, 1B, 2 and 3**) should either not be implemented or should be implemented in a manner that **excludes their application to the Pilbara Railways**.

The recommendations that relate to the 'ability to opt out' (recommendations **4 and 5**) and 'capacity extensions and expansions' (recommendations **6A, 6B and 6C**) are **supported in principle but subject to recommendation 7 being strengthened** to ensure that not merely frivolous but also vexatious and other ambit claims can be excluded if necessary.

The recommendations (recommendations **7-13**) that relate to 'improving the efficiency of the regulatory process' are largely **supported subject to concerns** about the standard access agreement being subject to regulatory approval (recommendation 9A; which is unnecessary and will be time consuming and costly) and the reduction in the prescribed time limit from 2 years to every year (recommendation 9B; which is clearly unnecessary for Pilbara Railways) and the need for the ERA to develop and maintain a model set of Part 5 instruments (recommendation 12; which 'the work associated with' will be back-charged to railway owners with no compensating benefits).

The requirement to publish service quality indicators ('Railway owner accountability; recommendation **14**) is **supported subject to exclusions** being granted under circumstances where that information is considered commercially sensitive.

The ability to hire additional expert opinion to provide guidance ('regulator accountability'; recommendation **15**) is **supported subject to that advice being genuinely expert advice** and not consultants with some knowledge gained in related fields but lacking expert knowledge that is actually pertinent.

Finally, the proposed change related to 'greenfield developments' (recommendation **16**) is **supported**.

2. SYNERGIES' COST BENEFIT ANALYSIS

Synergies Economic Consulting Pty Ltd (Synergies) undertook the cost benefit analysis {*Cost Benefit Analysis of a new pricing mechanism for rail access in WA*} which predicted positive net benefits as a result of implementing the new pricing mechanism. This report by Synergies (Report) was based upon assumptions and analytical inputs that Synergies regarded as indicative because they had not been tested with stakeholders (Report – page 5 of 19).

Not all key assumptions were explicitly identified, in some cases Fortescue has calculated the implied assumptions from the information provided in the Report. Those untested assumptions included:

a. The average number of proposals potentially wanting to undertake access negotiations was assumed to be 10 per year – Table 6 (page 16 of 19).
b. One third of these resulted in negotiations taking place; that is to say - there were 3.33 new negotiations per year (with 3 outside the Code and 0.33 inside the Code

under the Base Case; and 2 outside the Code and 1.33 inside the Code under the New Arrangements – Table 16 (page 16 of 19).

c. Negotiations under the Code as a result of implementing the new 'Pricing mechanisms' would be shortened by 1.5 years (Base case is '2.5 years' under Code and '1 year only' under New Arrangements; Table 6 – page 17 of 19).
d. Negotiations outside the Code would also be shortened by 6 months (from '1 year' in the Base Case to 'half a year' under New Arrangements – Table 6 - page 17 of 19) due to applications involving 'more complex negotiations' migrating from outside to inside the Code.
e. 20% of the value of any potential project is contingent on a 'rail access agreement' being secured.
f. The annual salary of 1 FTE associated with negotiating access agreements or compliance with the Code would be $165,000 p.a.

In addition, there were analytic inputs (i.e. derived from other facts or assumptions):

g. Based upon analysis of a data base provided by the Department of Industry, Innovation and Science (DIIS) it was estimated that the average value of a project potentially seeking access would be $300m (Report - page 14 of 19). Of which 20% ($60m) would be dependent upon rail access (see 5 above).
h. Projects will be brought forward by 1.5 years (this is listed as an analytic input since although it is described as an assumption it is dependent upon assumption 3 above).

2.1 Assumptions a & b - Average number of proposals and conversion to negotiations

It isn't clear what the raw number of 10 proposals per year is supposed to represent in terms of the location of those projects (proximity to railways covered under the *Railways (Access) Act 1998*) or nature of the product produced (as in 'whether rail services would be required', which, for example doesn't apply to gold projects in relation to transport of the final product). If we assume that the raw number of proposals takes no account of location (other than a requirement to be located in WA) or product (so that gold projects are included) then the assumed number of proposals is still significantly higher than would seem reasonable.

When Synergies attempted to estimate the value of resource projects that might be delayed due to protracted access negotiations, it accessed the DIIS data base covering Resource Projects in Western Australia. It found that there were potentially 6 projects that met the requirement of being 'Committed' and 'New Projects' within Western Australia as at October 2017. The six projects identified are instructive in terms of their locations and the types of products produced.

They were:

Project/Company	Location	Proximity to a regulated railway (< 50km)	Product	Requirement for bulk haulage
Browns Range/Northern Minerals	160 km SE of Halls Creek	No	Dysprosium dioxide	No
Dalgaranga Project/Gascoyne Resources	70km NW of Mt Magnet	No	Gold	No
Gruyere Project/ Gold Road Resources	140 km E of Laverton	No	Gold	No

Project/Company	Location	Proximity to a regulated railway (< 50km)	Product	Requirement for bulk haulage
Karlawinda/Capricorn Metals	60km SE of Newman	No	Gold	No
Pilgangoora/Pilbara Minerals	85km SSE of Port Hedland	Yes	Lithium	Possible but unlikely
Nova Bollinger/Sirius Resources	700km E of Perth	No	Nickel, Copper, Cobalt	No

Most of these proposals are not located within close proximity (less than 50 kilometres) of a regulated railway that could provide access and most of them wouldn't be interested in accessing a railway if one were available because their product is not a bulk product that would require sufficient haulage to justify investment in the associated above rail infrastructure that would be required. The only possible exception is Pilbara Minerals 'Pilgangoora Project' which were it to decide to export lithium ore in the form of low grade (~2%) lithium could require a bulk haulage service and is located close to the TPI and RHI railways (as well as BHP's Mt Newman railway which isn't regulated). However, the mine is located quite close to Port Hedland and it is unlikely that investment in rail (extensions and rolling stock and loading and unloading facilities) would be justified for such a short distance and quite limited volumes.

Also instructive is a comparison between this list and the same list published a year earlier which contained only 4 relevant projects. Two of the 4 projects stayed on the list, one was moved into development and one was subsumed into another company. The point being that under the widest possible definition of a resource proposal in Western Australia the expected number of new proposals is unlikely to be as high as 10. If the list of proposals is restricted to proposals located close to a regulated railway the number would fall dramatically and similarly if there was a filter that restricted analysis to proposals likely to require bulk haulage of the type provided by railways.

No explanation was given as to why approximately 1/3 of raw proposals were turned into access negotiations. However, when applied to the figure of 10 raw proposals per year it resulted in access negotiations commencing at a rate of 10 new negotiations every 3 years. That would appear to be around one order of magnitude too high. In other words, a more reasonable assumption would be that one new access negotiation would commence roughly once every 3 years.

The TPI railway has been operating since 2008. In just over 10 years there have been commercial negotiations with 5 entities that were interested in gaining access to the railway; however, 4 of those 5 entities were only interested in access to a complete package that involved above rail services and port services as well as the below rail service:

- BC Iron/Nullagine - gained access to such a combined service and operated successfully for about 5 years until the collapse in the iron ore price undermined the project's viability.
- Atlas Iron/'Horizon 1 Deposits' - gained access to port services on a temporary basis whilst suitable port facilities were constructed at Utah. Note that this was during Fortescue's ramp up whilst the port capacity was not being fully utilised. Atlas has been taken over by Roy Hill and is no longer a potential access seeker.
- Flinders (PIOP) - was unable to reach an agreement due to Flinders' requirement for port facilities that TPI was unable to offer due to limited port capacity.
- Brockman Mining (Wah Nam)/Marillana - an MOU related to a rail haulage and port services agreement was reached with Brockman Mining prior to its takeover by Wah

Nam. Wah Nam attempted to renegotiate the terms of the MOU and when that was not agreed to subsequently sought access to a below rail service under the Access Regime. At no time did Brockman Mining or subsequently Wah Nam demonstrate an ability to obtain capacity at Port Hedland that would be required to make any arrangement work. Wah Nam has subsequently signed a deal with Mineral Resources and no longer requires access to TPI's railway.

- Australian Aboriginal Mining Corporation/Wonmunna has signed an MOU covering a complete service and arrangements have subsequently progressed.

In the more than 10 years there was only one proposal that actually sought access to a below rail service and that proposal never demonstrated the financial capacity to fund the additional infrastructure required to supplement access to a below rail service and never even managed to demonstrate an ability to secure the port capacity necessary to underpin its development. In other words, at least in relation to TPI's railway, a generous interpretation of the rate at which raw proposals have come forward has been about one every two years on average and only one in ten years on average has progressed to attempted negotiations for a below rail service. Moreover, the rate at which raw proposals could be expected to come forward would be much higher in the early years than later on, because stranded projects which already existed and required access would seek such access soon after the railway was built, and subsequent proposals are then dependent on new deposits being discovered. In addition, since the RHI railway has been constructed in an area that largely overlaps with part of TPI's rail catchment area the number of raw proposals likely to come forward requiring access to the RHI railway will not represent a net increase. It is quite simply fanciful to suggest that the two regulated railways in the Pilbara might attract on average even one proposal per year seeking access to a below rail service and seeking to undertake access negotiations.

2.2 Assumption c - Negotiations (inside the Code) shortened by 1.5 years

According to Synergies the **main factors** contributing to the speeding up of negotiations would be (Report – section 3.1 - pages 11 &12):

- The utilisation of standing offer tariffs where criteria are met;
- The utilisation of regulatory endorsed standard access agreements;
- The provision of pricing guidance in circumstances where alternate competitive transport solutions mean that access charges are set below the ceiling; and
- Clearer guidance regarding the impact of age and/or condition of assets on asset value.

Synergies went on to state "*We anticipate that the negotiation times could be reduced, on average, by 1.5 years for each access agreement that is negotiated under the Code*". No justification was given for why it was supposed that the four factors mentioned would result in a 60% reduction in the time taken to negotiate an agreement under the Code, but it seems to be a rather heroic assumption.

The Utilisation of Standing Offer Tariffs

As the Draft Decision Paper acknowledged – "*A standing offer is similar in form to an indicative tariff, but without the regulatory approval process associated with a tariff*" (section 3.3.3 – page 27). So, whilst a 'indicative tariff' is regulatory approved standard price for access, its cousin the 'standing offer' is the same thing but without any regulatory approval and therefore no obligation for the railway owner to use it as the basis for negotiations.

"*Standard offers are used in electricity markets in other jurisdictions in Australia, where competition has been deemed to be effective enough to remove regulated tariffs, but there is a*

need to provide a signal to customers about what a reasonable price to pay might be" (Draft Decision paper – section 3.3.3 – page 27). The Draft Decision paper went on to acknowledge that although there were differences between rail and electricity markets, the concept of having a standard offer for certain rail tasks, to provide a signal about what an efficient price (between floor and ceiling) ought to be, had merit. However, the use of standard offers in the electricity markets exists because competition has removed the need for regulated tariffs (i.e. there is already sufficient competition that competitive forces will ensure that pricing is efficient) and it is entirely a signalling exercise so that potential customers are not deterred from approaching suppliers because they harbour unrealistically high or otherwise unrealistic expectations concerning what price would be asked for. That is clearly not the situation in the market for below rail services where potential access seekers would already have a very good idea concerning what they thought was an appropriate price. Moreover, at least in relation to services associated with the below rail element of transporting bulk products on heavy haul railways in the Pilbara, there is highly unlikely to be a standardised service that would cover the requirements of typical access seekers for who a standard price and standard terms and conditions would be appropriate.

The notion that a standing offer indicating the price at which some homogenous service could be accessed for, unsupported by any regulatory force, would somehow entice in new access seekers that were previously deterred by ignorance about reasonable prices is not something that can be supported. To suggest that it would subsequently lead to a reduction in the time required to reach a negotiated agreement under the Code is quite frankly fanciful. In the context of heavy haul railways in the Pilbara, the biggest issue is the vertically integrated nature of the operations which leaves the vertically integrated operator reluctant to allow access seekers onto the railway for fear that they may disrupt operations causing significant losses in the upstream and downstream parts of the vertically integrated entity. This inevitably leads any vertically integrated railway operator to seek the highest possible price for access to compensate for the perceived risks. The corollary to this is that any rational operator of a vertically integrated railway is likely to post a standing offer tariff that reflects the ceiling price (which is allowed as there is no regulatory control over this) and since this is already calculable under the existing regime it isn't clear that it would actually achieve anything.

The Utilisation of Regulatory Endorsed Standard Access Agreements

The use of regulatory endorsed standard access agreements was never given any detailed analysis in the Draft Decision Paper. It simply appears in the section on 'Standing Offer' {section 3.3.3} under the subheading 'How this would be implemented' where it states "*The railway owner would be required to develop standard terms and conditions to underpin the standing offer, including service standards associated with that price. This would also* ***not need to be approved by the regulator***". It is not clear whether it is proposed that the standard access agreement containing the standard terms and conditions does or does not require regulatory endorsement – the Synergies Report suggest that it does whereas the Draft Decision Paper suggests that it does not. It is also not clear how this standard agreement relates to the standard access agreement discussed in section 7.3.3.

A standard access agreement which sets out the standards terms and conditions associated with access is only really relevant where an access seeker is likely to want standardised access that corresponds with what would be covered under such standard terms and conditions. – that is not likely to be the case for those seeking access to the Pilbara Railways. The Draft Paper suggest that this would include such matters as "*service standards associated with that price*" – and this really highlights the differences between the nature of passenger rail services and regular freight running to a defined schedule (where this is of relevance) and the operations in the Pilbara that

are completely different. For a potential access seeker seeking access to a below rail service associated with the bulk haulage rail systems in the Pilbara there will not be 'standard terms and conditions' or even variations from standard terms and conditions because the terms and conditions will need to be tailored exactly to deal with the interaction between existing operations, that in the Pilbara are all essentially based upon a 'co-ordinated run when ready' approach to scheduling. The access seeker will require flexibility in scheduling but also a level of certainty that that flexibility doesn't translate into service denial for extended periods when the incumbent's operations require surge capacity or due to the scheduling of maintenance operations being targeted into the slots associated with the access seekers schedules. Also due to the heavy haul nature of the railways, standard terms and conditions would need to extend to such matters as axle loading limits, weight distribution on individual wagons, wheel profiles and limits on variations, ability to maintain particular minimum speeds on sections, and required stopping distances. Most of these are interrelated so that, for example, the proposed axle loading would determine the limit of weight distribution within wagons.

Even supposing that standard terms and conditions could be constructed that would be relevant to an access seeker seeking access to a below rail service on one of the railways in the Pilbara and supposing even further that these standard terms and conditions were given regulatory approval – it isn't clear how this would translate into a meaningful reduction in the time required to negotiate an access agreement under the Code. In essence Synergies is suggesting that the existence of standard terms and conditions which would mostly be irrelevant to the finally negotiated terms and conditions of any consummated agreement would somehow act as a starting point that would speed up the negotiations compared to what would happen if there were no standard terms and conditions on-the-shelf to act as a guide. This is really only credible under circumstances where an access seeker has no real knowledge of what appropriate terms and conditions should look like and would therefore find the off-the-shelf terms and conditions a useful starting point. But we are discussing an access seeker who is seeking access to a below rail service in order to be able to operate an above rail service upon it (as opposed to an access seeker wanting haulage). Any entity that can credibly operate an above rail service on the 'rail and below assets' of a Pilbara based heavy haul railway would have knowledge about the terms and conditions that would be required to make such an operation operate effectively and some standard terms and conditions would not be necessary as a starting point guide.

In section 7.3.3 of the Draft Decision Paper the point is made that access seekers have little confidence that standard access agreements provided at the beginning of the process would reflect the final terms and conditions. It is not clear why they have now been elevated to the status of something that will contribute to reducing negotiating times.

Guidance from Competitive Imputation Pricing

The notion behind this factor is that if there existed a guide price based upon an assessment of competitive alternatives to rail that this guide price could speed up negotiations by causing the negotiating parties to recognise that it represented a new ceiling on access pricing and that the railway owner would take this into account and lower the required access price to this new level. Moreover, the Draft Decision Paper (Table 8) suggested that even if the railway owner didn't take this into account any arbitrator would take it into account in arbitration and that this would speed up the arbitration process. Even if this was theoretically true (which it probably isn't), it would not be relevant in the context of the Pilbara railways since the competitive imputation price would be significantly above any likely ceiling price.

There are basically two aspects to an access agreement covering a below rail service:

(i) the price which could be as simple as a fixed fee for a particular rail slot along a defined section of track or more likely a fee calculated based upon the gross weight of the train and the distance traversed measured as a fee per tonne kilometre; and

(ii) the associated terms and conditions which would cover amongst other matters - scheduling, priority, and technical specifications that the rolling stock would be required to adhere to, and penalties associated with non-performance.

A vertically integrated railway owner (that doesn't really want third parties running on its track but will dutifully allow access due to obligations contained in the regulations) is always going to ask for the maximum price and focus all its attention on the terms and conditions with a view to minimising potential disruption of its existing operations. The fact that an access dispute comes under the Code means that commercial agreement has not been able to be reached. A guide provided by a competitive imputed price is not likely to change the railway owner's position when the negotiations are transferred to being under the Code. If the negotiations ultimately end up going to arbitration over the price (rather than the associated terms and conditions) it seems unlikely that the process of arbitration would be significantly speeded up by the existence of an imputed competitive price. If the dispute is about terms and conditions the existence of an imputed competitive price wouldn't make any difference.

However, in the context of railways in the Pilbara, an imputed competitive price derived from considering road haulage as an alternative would likely result in an imputed price well above any ceiling calculated under the Regime. A 'ball park figure' for the cost of hauling iron ore by road would be, say 10c per tonne kilometres which over a 300-kilometre journey would equate to $30/t moved. A ball park figure for a rail haulage service over that same distance (assuming the product was iron ore and the volume involved was sufficient to keep a single consist fully employed) would be around $10/t of which around $3.50/t would be to cover the above rail service and $6.50/t would cover the below rail element. So, assuming that there were no differences in quality that needed adjusting for, the competitive imputed price for access to the railway would equate to about $26.50/t.

There is simply no way that a competitive imputed price based upon the alternative of road haulage over long distances in the Pilbara would do anything to change the time taken to negotiate an access agreement – indeed it would likely empower railway owners into hanging out for a higher price.

Clearer guidance on the impact of age or condition on appropriate price

There are a number of premises hidden within this factor and its alleged ability to cause a reduction in the duration of negotiations:

- It assumes that the existing arrangement (GRV valuation) results in an outcome where the value of the underlying assets is inflated due to a failure to incorporate adjustment to the asset values to reflect deterioration due to age or use; and therefore, that the railway owner seeks too high a price based upon inflated asset values.
- It assumes that under the proposed new arrangements (DORC) the asset values are more closely aligned with the condition of the underlying assets and therefore realistic access prices are sought due to the ceiling price being dragged closer to what is justified given the condition of the assets.
- It also effectively assumes that the assets concerned have aged and/or deteriorated over sufficient length of time that material differences have developed. That would not be true

for young railways and would also not be true for heavy haul railways in the Pilbara where the high axle loadings which run close to the limits of the infrastructure require heavy ongoing investment in maintenance, repairs and upgrades to keep the assets in good condition.

The notion being put forward is that changing from the GRV methodology to the DORC methodology will effectively reduce the ceiling price (particularly for older railways) and push up the floor price (again particularly for railways in poor condition that have higher maintenance costs) and that this narrower negotiating band would result in a reduction in the time taken to negotiate a commercial agreement, or failing that for an arbitrator to set the price. Such an outcome seems highly unlikely to occur in the context of access negotiations for a below rail service for what are relatively new heavy haul railways operating in the Pilbara for the following reasons:

i. Protracted negotiations are far more likely to be centred in differences concerning the associated terms and conditions of access than the actual price.
ii. Both the heavy haul railways in the Pilbara are relatively new and therefore the ceiling price will not be significantly reduced.
iii. Both the heavy haul railways in the Pilbara will be being maintained in a manner that ensures that the service provided by the 'rail and below assets' is not significantly different from an as new service –this would be factored into the maintenance costs meaning the floor price would not alter much with the change in methodology.
iv. Assuming that terms and conditions have been agreed and that differences have been isolated to a disagreement over price – it isn't clear why a slightly reduced ceiling would cause a significant reduction in the time taken to negotiate a commercial outcome or if such an outcome can't be reached why a slightly lower ceiling price would enable an arbitrator to impose a solution any more quickly.

Overall

The three of the four main factors which are hypothesised to reduce the time taken to reach a commercially negotiated outcome or one imposed by an arbitrator are all factors which rely purely upon guidance related to the potential price for access being sufficient to cause a drastic reduction in the time taken to reach an outcome. The fourth factor relied upon standard terms and conditions providing guidance where at least in terms of the Pilbara heavy haul railways such guidance would be of no relevance to potential access seekers given the heterogeneous nature of any access requirements.

Any potential access seeker to the heavy haul railways of the Pilbara, that has the capability to operate an above rail service (haulage) on the existing infrastructure is not going to be greatly assisted in reaching a commercially negotiated outcome by the existence of guidance terms in the form of either prices or standard terms and conditions. At best such guidance would reduce the negotiating time required by a matter of weeks; it is simply not credible to suppose that these four factors could collectively reduce the negotiating time by 18 months.

2.3 Assumption d - Negotiations (inside the Code) shortened by 6 months

The explanation given by Synergies as to why negotiation times for access agreements being negotiated outside the Code would be halved was "*due to many more complex proposals now being negotiated under the Code*" (Report – page 12 of 19). This explanation implicitly relies upon the 'new arrangements' being better at dealing with complex proposals than 'current', so that access seekers with complex proposals are encouraged to switch into negotiations under the Code because the 'new arrangements' are better at dealing with that complexity and reaching an

outcome. But in terms of the main factors reducing the negotiating times taken to reach an outcome – three of those four were guidance related to the price for access and the fourth was standard terms and conditions which are less likely to be relevant to complex proposals than others. In short there is nothing in changes proposed for the 'Pricing mechanisms' that would suggest that complex proposals would benefit from being under the Code more under the 'new arrangements' than under the 'current'. And if complex proposals are no more encouraged to use the Code under the 'new arrangements' than under the 'current', it is illegitimate to suppose that any proposals that would have been previously negotiated to completion outside the Code would be encouraged to switch into the Code or that negotiations outside the Code would be expected to be reduced by 6 months.

2.4 Assumption e - 20% contingent on rail access

The assumption underlying Synergies' valuation of the costs associated with lengthy access negotiations is that whilst access negotiations continue, investment related to that aspect of the project which is contingent upon rail access is held up and that this delay represents a cost. Furthermore, Synergies has supposed that the amount being held up (and contingent upon rail access) is a constant 20% of the overall value of the project.

The 20% assumption makes no sense. If we assume that the access seeker has a 'resource project' located in the Pilbara which it is seeking to develop and it requires access to the railway in order for the project to proceed, then in most circumstances it is the entire value of the project (100%) that is held up. Taking Synergies' example of a $300m project – no sensible project developer would invest $240m in developing the non-rail aspects of the project and postpone only the $60m that was contingent on a rail access agreement being secured. Synergies was not specific about what the 20% was intended to cover, but it is assumed to be everything required to be able to provide a rail haulage service on the track and that would necessarily also include both loading and unloading facilities. Indeed, for bulk haulage in the Pilbara the investment required would also need to include the infrastructure required to provide all port services – so in addition to train unloading facilities there would also need to be investment in facilities to provide stockpile services and investment in facilities to provide vessel loading services. Also not discussed was the investment required to connect the mine site to the existing railway and to connect the existing railway to port facilities at the other end. If we suppose that the access seeker is located 35 kilometres from an existing railway and requires an additional 15 kilometres of track from the existing railway to get to unloading facilities near the port, that represents 50 kilometres of track which valued at $6m per kilometre (see appendix 3 of Draft Decision Paper) would amount to an investment of $300m just for extensions at each end of the railway. The access seeker would still need to invest in locomotives and wagons, facilities for loading the train and facilities for unloading it and all the infrastructure required to support the rail operations such as a marshalling yard and maintenance workshops. The size of this investment bears very little relation to the value of the project.

There is a very good reason why most entities seeking access to heavy haul railways in the Pilbara want access to a haulage service and preferably to associated port services as well – because the capital costs associated with providing the service of transporting a bulk product from a mine site to port facilities via an existing railway still requires significant investment that is unjustifiable for small to medium sized potential projects; and the associated port services are equally costly in terms of the capital required assuming that port capacity is actually available (which it mostly isn't).

2.5 Assumption f - The salary of people undertaking access negotiations

Synergies assumed that all the costs of all the people involved access negotiations and regulation could be calculated off a single FTE number being a salary of $165,000 per year. In terms of commercial negotiations between access seekers and railway owners under the Code – it was assumed that each party incurred 4.5 FTE equivalent costs over two and a half years.

Fortescue maintains that given the significance of the commercial implications of such negotiations utilising a base cost of $165k pa is wholly inadequate to reflect the seniority and competence of the people likely to be involved; it is at least 50% too low. In other words, once other employment costs have also been factored in, the costs of a single FTE for a year should be at least around $250k pa; that means that the unit cost of negotiation should be increased from $742,500 per proposal per year to $1,113,800 per proposal per year. Fortescue also believes that similar underestimation of the costs of the people involved has been made across the board and that all costs involving people costs should be increased by around 50%.

2.6 Assumption g - Average value of Projects

Synergies accessed the DIIS database for Western Australian projects and based upon analysis of this data base used an assumed figure of $300m as the average value of a proposal. The projects used as the basis for calculating the average value of a proposal were mainly relatively small gold projects; they bear no relationship to the size of project likely to be seeking access to an existing Pilbara railway for the purpose of self-providing a rail haulage service over the existing infrastructure.

2.7 Assumption h - Projects brought forward by 1.5 years.

Starting from the assumption that as a result of the 'new arrangements' negotiations under the Code would be shortened by 1.5 years, Synergies then further assumed that this would also result in the development of projects being brought forward by 1.5 years or at least, that element of the project that was dependent upon rail access being brought forward by 1.5 years.

Leaving aside the issue of whether 20% or 100% of the project is delayed as a result of protracted rail access negotiations, the assumption that 1.5 years of extra rail negotiations results in 1.5 years of delay in the investment in some aspect of the project displays a fundamental lack of understanding about the development of resource projects. New resource projects start with exploration and the finding of a potentially commercial deposit. When the resource is identified, and a Mineral Resource is announced to the market, all that has been achieved is the identification of mineralisation and the potential to be a commercial deposit. The next phase involves a high-level assessment of the commercial viability (usually a scoping study or a pre-feasibility study is undertaken) to a level that gives satisfaction that the deposit is worth exploiting (i.e. it is commercially viable given certain assumptions). At the same time, further resource definition is usually undertaken (more drilling) to increase the certainty associated with the resource to a level that enables it to be converted into an Ore Reserve and other studies are implemented such as those necessary to underpin environmental approvals. For a significant project in the Pilbara (large enough to require rail access) the approvals process will probably involve a Public Environmental Review (including an Environmental Scoping Document and then undertaking of all the required studies) which could be expected to take at least two years to complete. Once the resource definition has been sufficiently improved and a study has verified the commercial viability of extracting the resources, the Mineral Resources can be moved into the category of Ore Reserves. For a significant project involving processing infrastructure at the mine site and supporting facilities (accommodation camp, catering facilities, air strip, power and water) the associated capital costs will usually be refined by undertaking a Definitive Feasibility Study before the final investment will be made. Moreover, if that final investment is going to be

underpinned with bank investment, further drilling will likely be required to ensure that the Ore Reserve is large enough when mined according to the mining schedule to cover the scheduled debt repayments. The time taken to move from the initial Mineral Resource to the final Ore Reserve that underpins the financing with environmental approvals completed to the point where construction could commence would be expected to take at least three years and often as long as five years or more.

Once the Mineral Resource has been defined the project developer will be aware that there is a potentially commercial project and will also be aware of the need or otherwise for rail haulage to make the project viable. At this point rail access negotiations could commence whilst the project developer is still more three years away from the Final Investment Decision (FID; when funds are finally committed). If rail negotiations are commenced at the earliest possible opportunity there is more than three years available for negotiations before 'protracted negotiations not being completed' will result in the FID being delayed.

Even if we suppose that the developer of the proposal is a little tardy in commencing rail access negotiations and delays commencing until 2.5 years before the FID is scheduled, shortening rail access negotiations from 2.5 years to 1.5 years make no difference to when the Final Investment Decision is implemented because it isn't the determining factor in when such a decision is made. It is simply wrong to assume that shortening rail access negotiations necessarily results in associated investment being brought forward.

2.8 Overall cost/benefit analysis

Table 7 of the Report (page 18 of 19) lists the present value of the benefits and costs of moving from the 'current' to the 'new arrangements'. Assuming a 7% discount rate, the present value of the benefits was calculated at $35.7m and the present value of the costs was put at $11.3m, resulting in a net gain of $24.4m. The present value of the benefits ($35.7m) can be further disaggregated into the present value of the benefit of reduced negotiating costs of approximately $11.8m (33%) and the present value of the benefit attributable to the bringing forward of projects of approximately $23.9m (67%).

The calculation of the net benefit is heavily dependent on a number of questionable assumptions:

- **Proposals** - The assumption that there would be 3.33 new negotiations commencing each year. Based upon 10 raw proposals of which 1/3 proceed to negotiations
    - A more reasonable assumption would actually be about 1/10th of that amount – i.e. there is 1 new proposal every 3 years.
    - If the number of proposals was reduced to 1/10th of the level previously proposed (with a consequent impact on both the number of negotiations being undertaken and the number of proposals brought forward) the calculated benefits would fall proportionately
        - The benefit associated with reduced negotiating costs would fall to approximately $1.2m
        - The benefits associated with projects being brought forward would fall to approximately $2.4m
        - The costs associated with the new pricing mechanism would remain at approximately $11.3m
        - The overall net present value of $24.4m over 20 years becomes a negative value of approximately minus $7.7m

- **Negotiations (i)** - The assumption that the new arrangements shorten negotiations under the Code by 1.5 years or 60%
    - A more reasonable but still very optimistic assumption would be that negotiations under the Code would be shortened by at most 3 months or 10%.
    - If negotiations under the Code were shortened by only 3 months (as opposed to 15 months):
        - There would be no benefit attributable to reduced negotiating costs because under the remaining assumptions used by Synergies it would result in an increase in negotiating costs compared to the base case. The $11.8m benefit would become a cost of $1.3m.
        - If negotiations are only shortened by 3 months, then the associated projects will only be brought forward by 3 months and the associated benefit would fall by 84% (based upon a 7% discount rate) from $23.9m to $3.8m.
        - Since the costs associated with the new pricing mechanism would remain at $11.3m the overall net present value of $24.4m over 20 years would become a negative value of approximately minus $8.8m
- **Negotiations (ii)** - The assumption that negotiations outside the Code were shortened by 6 months
    - There was no reasonable justification for that assumption and therefore negotiations outside the code should stay as assumed to take one year.
        - Under the assumptions used by Synergies (see table 3 of Report) the majority of the estimated benefit from a reduction in negotiating costs was attributable to the reduction in negotiating costs outside the Code (because some switched into the Code).
        - If there is no reduction in the time taken to negotiate proposals outside the Code, then the calculated costs saving would be reduced by 67% from $11.8m to $3.9m and the overall net present value would be reduced from $24.4m to $16.8m.
- **Value delay** - The assumption that 20% of project value was contingent upon rail access and would be delayed until it had been determined
    - A more reasonable assumption would be that 100% of project value would be delayed until rail access negotiations had been determined, the project value would be greater than $300m but there would be no detrimental impact on the FID unless the negotiations took longer than 3 years.
        - The value of the project is immaterial if no delay is caused to projects.
        - If there is no delay caused to projects, then the entire $23.8m benefit is lost.
- **Salaries** - Underlying salary costs can be based off an FTE rate of $165,000 per year
    - A more reasonable assumption would be based off the full costs assumed to be about $250,000 per year or an increase of 50%.
        - The benefits of reduced negotiating costs would be increased by 50% or $5.9m to $17.7m
        - The costs associated with the new pricing mechanism would also increase by a similar amount meaning the net impact would not be significant.
- **Overall –** the impact from the various changed assumptions are not additive. Fortescue believes that the following represents reasonable assumptions on a collective basis:

- The number of proposals and hence access negotiations and projects brought forward are all reduced by a factor of 10.
- Negotiations under the Code (which have been reduced by a factor of 10) are also only shortened by 3 months under the new arrangements (as opposed to 15 months) and the duration of negotiations outside the Code are unaltered and so no proposals switch from outside to inside the Code.
- No projects are actually brought forward since rail negotiations aren't a determining factor in the timing of FID.
  Assumed labour costs are increase by around 50%.

The net result of these changed assumptions would be that the overall present net value of $24.4m would become a **negative impact of $17.6m** with that number comprising a negative cost from the new pricing mechanism of $17.7m offset by the trivial impact ($0.1m) of a very occasional proposal having negotiations under the Code shortened by 3 months but without the impact of any associated project being brought forward.

The Synergies' Report was claimed to constitute a robust framework for assessing the costs and benefits of the proposed changes to the pricing mechanism. Fortescue's analysis has attempted to use the proposed framework with adjustments to represent more reasonable assumptions. This new analysis suggests that implementing DORC with the recommended transitional arrangements, as well as standing offers and competitive imputation pricing would not result in any net benefits but rather it would impose costs of around $17.7m on railway owners (since they would be charged for additional costs incurred by ERA) in order to generate at most about $0.1m of benefits making an overall net cost of $17.6m, as compared to Synergies' assessment of a net benefit of $24.4m.

It was further claimed that Synergies' estimate of net benefits was an underestimation due to the difficulty of quantifying some of the benefits and that therefore the net benefits were likely to be somewhat higher. The unquantified additional benefits were derived from the following:

- Net cost savings due to fewer disputes under the Code
  - The rationale given for there being fewer disputes under the Code was the same rational for why negotiating costs would be lower.
  - The same reasons that were give earlier as to why the negotiating time was unlikely to be significantly shortened would apply in relation to the number of disputes – namely it is unlikely to make much difference.
  - In addition, Synergies' analysis in section 3.2 of the Report – Table 4.2 – showed no significant difference between the two arrangements (the small difference in the illustrative example was actually caused by rounding errors in their calculations).
- Lower risk of good projects not coming to fruition
  - Synergies claimed to "*suspect*" that there were at least some 'good' projects that were commercially viable that didn't proceed and were effectively abandoned because of protracted negotiation timeframes and associated transaction costs, which meant that they missed the investment window.
    - There is no evidence that supports this suspicion – the evidence to date is that there have been no commercially viable projects that commenced negotiations but then subsequently missed the investment window and had to be abandoned.

- Synergies is perhaps confusing 'commercially unviable projects that sought subsidised access to make their project viable and when it wasn't available were unable to proceed' with 'good projects'.
- Note that whilst protracted negotiation timeframes might cause an 'investment window' to be missed the associated transactions costs do not.

- Increased durability of negotiated agreements
  - Synergies claimed that access agreements made under the revised Code would be more 'durable' and more 'robust' in being able to address a range of future circumstances.
    - It is not clear why any agreement made utilising standard offer tariffs, regulatory endorsed standard access agreements, an imputed price for competitive alternatives and clearer guidance regarding the impact of age and/or condition of assets on asset values would result in an agreement that was more robust in situations where the circumstances have subsequently changed. Synergies' claim is simply asserted without justification.
  - Synergies also claimed that subsequent negotiations would be less likely to involve a re-opening of issues that had previously dealt with because there would be established precedent in how issues were to be addressed and resolved.
    - If disputes or disagreements about matters are resolved by negotiations, then a precedent has been established about how that matter should be resolved regardless of the underlying pricing mechanism involved. There is no justification for claiming that the new arrangements would follow that precedent.

Synergies' claim that the net benefits would be likely more than the $24.4m that they calculated is unwarranted. The large and certain upfront costs overwhelm the trivial benefits and the alleged additional benefits that could not be calculated would not alter that outcome.

3. DRAFT DECISION PAPER RECOMMENDATIONS

3.1 Recommendation 1A

Change the asset valuation methodology to a building block based on an initial DORC valuation and align the floor and ceiling cost calculations with the DORC method.

The recommendation to change from a GRV methodology to a DORC methodology is primarily based upon the notion that the GRV methodology imposes costs that outweigh its benefits and so requires replacing and that the DORC methodology used by other regimes represents a better alternative.

The alleged costs associated with the GRV methodology (Table 1 – page 9) were:

1. *The ceiling does not necessarily reflect the asset's current condition or the economic value a user may expect to extract from an asset, and therefore allows for monopoly profits in some instances. This can compromise efficacy of negotiations where the ceiling does not reflect what could be achieved in a competitive market for rail facilities.*
   a. The differences between the GRV and the value based upon the actual condition of railways in the Pilbara is not going to be significant and therefore not going to impose costs caused by this difference.

b. It is simply not the case that an access seeker to a railway in the Pilbara is likely to be impeded from extracting value from the rail asset due to its poor condition.
c. If a railway owner is able to extract a 'monopoly profit' by charging a rate above what would be sustainable in a contestable market – that does not actually constitute an overall cost – it is simply a transfer of value between the two entities. It would only be a cost if as a result of this additional charge the access seeker was either deterred from gaining access or sought less access – it is the '*deadweight losses*' that represent a cost to society.
d. There is an implicit suggestion in the analysis that the ceiling should be at the same level as would prevail in a competitive market for rail facilities. This represents a misunderstanding of the economics involved here. In a perfectly competitive market, the price would actually be the floor price because price would equate to marginal cost. Railways demonstrate both discontinuity in supply (lumpiness) and significant economies of scale (high initial capital cost and lower marginal costs) which means the conditions for perfectly competitive market cannot prevail. In an imperfectly competitive market entry and exit would result in a price that equated to the average cost of providing the service which would include a normal return on the capital required to be invested in order to be able to provide the service. That is to say new entrants would be attracted to the market and would invest in rail facilities up until the point where the price was driven down to the point where further new investment by new entrants was no longer justified because the price only covered a normal return on the investment required. The same price should prevail in a contestable market and that is the theory underlying the Object of the *Railways (Access) Act 1998* – namely that the regime encourages efficient investment in railways by facilitating a contestable market for rail operations. In other words, the price should be driven to the contestable market price which would be one where the price equated to the average cost of providing the service. The contestable market price is, at the limit, the price at which new entrants would just be deterred from investing in new facilities to replicate the service and that is the price which covers a normal return on the investment required to build new facilities at current prices. It is not a normal return on the depreciated value of the existing assets (adjusted for optimisation considerations), it is a normal return on the investment required to replicate the facility (i.e. the gross replacement value).

2. *The floor price may not cover real operating and maintenance costs for lines that are nearing the end of their useful life and is therefore not an economically efficient cost and does not assist negotiations, particularly for older lines that have not been well maintained*.
    a. It is alleged that under the GRV methodology the floor is not the actual annual operating costs but rather the average annual operating costs over the lifetime of the asset – which will have a tendency to overestimate operating costs associated with new assets and underestimate operating costs associated with old assets that have higher maintenance requirements.
    b. This is not strictly true for the railway lines operating in the Pilbara. The rails are subject to regular maintenance which is a function of above rail usage rather than the age of the asset. The rails are also actually replaced in a regular basis

dependent upon wear rates. Similarly, the ballast underlying the railway is maintained and replaced cyclically. The overall effect is that the railway does not have associated maintenance costs that rise continuously with the age of the asset; the profile is much more likely to be 'a brief period when there are lower maintenance costs' for a new railway once it has properly bedded down, and thereafter maintenance costs should be relatively stable over the remaining life of the railway as components are regularly replaced with new ones as wear and deterioration dictates.

c. The assertion that GRV floor costs are not economically efficient and therefore don't assist with negotiations is not warranted. There is nothing that prevents the railway owner from introducing actual operating costs into commercial negotiations and arguing that they are above the floor and that this should be taken into account.
d. If actual operating costs are used instead of lifetime average costs it will result in a floor price that varies over time and would rise considerably if a significant maintenance program was undertaken in one particular year. It is difficult to see how having a floor price that is highly variable and uncertain on annual basis would present a better guide to potential access seekers that a floor price that was stable and effectively certain in future periods.
e. As the Department has acknowledged this is really only relevant to older lines that have not been well maintained – in other words it doesn't apply to new railways that are well maintained such as the Pilbara railways.

3. *Uncertainty about the ceiling over time (because it is re-assessed based on the current value of modern equivalent infrastructure when a proposal is made) can introduce uncertainty for when an agreement has to be re-negotiated or when a potential access seeker is considering a future access application*.
    a. This was listed as a cost associated with the GRV methodology. It should be viewed in the light of the illustrative example of GRV versus DORC in Figure 2 of the Draft Decision Paper in which GRV is shown as a constant value as compared to DORC which varies considerably over the lifetime of the asset.
    b. The argument is that GRV is based upon the current value of modern equivalent infrastructure which can be re-assessed when a proposal is made. However, in the context of the below rail infrastructure of heavy haul there is almost no scope for changes in technology (so that a modern equivalent will be no different from what was built) so all we are really talking about is an increase in underlying costs. This is hardly going to insert a high degree of uncertainty. Elements can be tracked using CPI data and other price guides and it is worth remembering that access seekers are entities capable of running heavy haul railways who will have good knowledge of the associated costs and how they are likely to vary over time.

4. *Where an asset is expanded, the actual expansion costs may be significantly higher than the resulting increase in GRV. This may constrain an infrastructure provider from recovering the full expansion costs in access charges, which may discourage investment*.
    a. There is problem with valuing new infrastructure in brownfield situations (as opposed to greenfield) where operating constraints may considerably increase the cost of developing the infrastructure (such as having to construct without

interfering with existing operations). But this problem is common across the valuation methodologies. The reason why it is listed as a cost for the GRV methodology in the Draft Decision Paper is that it is assumed that under GRV the owner is only allowed to incorporate greenfield costs where brownfield costs were incurred. In contrast it has been supposed that under DORC the actual cost as incurred is allowed to be incorporated. But this latter assumption is incorrect since DORC requires that the actual cost incurred should be adjusted to the extent that what was built was not optimised (i.e. it avoids 'gold plating'). If the DORC methodology undertakes the optimisation calculation against greenfield costs the same problem occurs. If it is allowed to calculate the costs against brownfield costs, then the same could be allowed to GRV assessments.

b. In the event that the expansion cost is significant and the infrastructure provider believes it is unable to properly recover the full expansion costs through access charges – it would be entitled to demand that the access seeker should pay the costs directly and the cost recovery issue would be avoided.

5. *Where access negotiations fail to achieve an outcome, the floor and ceiling prices do not necessarily provide useful guidance to the arbitrator*.
    a. This is merely a repetition of the same point made under 1 and 2 above only related to arbitration rather than commercial negotiations and the same responses are also appropriate.

6. *The GRV approach is not consistent with other access regimes and may create additional regulatory burden for parties operating across jurisdictions*.
    a. The regulatory burden is effectively placed entirely upon infrastructure owners. Infrastructure owners in WA will incur a significant burden resulting from transitioning from GRV to DORC and then will incur additional ongoing compliance costs (that will be higher than under DORC).
    b. The only cost that is relevant when assessing the costs of inconsistency between regimes which is associated with the 'GRV methodology' is a cost that would be reduced by changing to a 'DORC methodology' as a result the economies of complying with a single regime being lower. However, the Synergies Report clearly showed an increase in compliance costs and it makes no sense, and there is no evidence to support the notion, that infrastructure owners' costs would somehow fall by more than this additional extra cost as a result of unspecified benefits from operating under a common regime across jurisdictions.
    c. This is not an issue of relevance to the Pilbara Railways which don't operate across jurisdictions.

The alleged benefits associated with the DORC methodology (Table 2 – page 13) were:

1. *The ceiling will more closely reflect the service potential and actual costs incurred by railway owner given the condition of the asset, which should assist negotiations by providing more realistic guidance on the maximum price*.
    a. This is simply the same argument that was listed as a cost of the GRV methodology listed as 1. above; the same responses 1.a. – d. apply.

b. However, it is worth repeating that the essence of this argument is that DORC will set a lower ceiling price that more closely reflects what would be considered competitive pricing considering the condition of the assets and that this would assist negotiations.
    i. This discrepancy not exist in the railways of the Pilbara because the condition is maintained in effectively as new condition;
    ii. Further, lowering the ceiling price is unlikely to assist negotiations to reach a conclusion – quite the contrary. A lowering of the ceiling price (which is already likely to be too low to encourage the railway owners to seek the benefit of revenue from potential access seekers) is merely going to discourage the railway owners from making strong attempts to find the necessary compromise that would make access feasible to a railway that doesn't run to a schedule and effectively utilises the full capacity of the system as a result.

2. *The floor price will include all forward-looking costs of providing the route, including maintenance costs (given actual condition), major periodic refurbishment and necessary asset renewal. This is consistent with setting a floor price that constrains clearly inefficient pricing and will assist with negotiations, particularly for older lines that have not been well maintained*.
    a. If access negotiations are based upon a floor price that is projected forward over the duration of the access agreement and is based upon the railway owner's estimate of these forward looking costs, then the whole system becomes open to abuse whereby railway owners that haven't properly maintained their assets are able to hypothesise significant future maintenance costs that push up the floor significantly.
    b. The notion that a higher theoretical floor under DORC is a benefit due to it preventing inefficient pricing at below the real level of the floor is misplaced. The floor is simply a guide to negotiations and there is nothing that prevents a railway owner faced with negotiations under GRV from introducing evidence that actual costs are above the GRV and therefore adjustment should be made to reflect this fact. The price is supposed to be determined by negotiations in a range between ceiling and floor and if actual costs are above the GRV floor that fact would be part of the negotiations.

3. *Avoids uncertainty about future valuations of the ceiling, since the initial RAB under DORC is 'locked in' when first calculated and then updated each year to reflect depreciation and efficient investment in the asset*.
    a. There seems to be some misunderstanding here about what the ceiling comprises. The ceiling is the addition of the annual capital cost and the annual operating cost. So, whilst it is agreed the value of the annual capital cost element is 'locked in' in the form of an initial regulatory asset base (RAB) – that only covers one element of the ceiling cost. The annual operating costs does not benefit from reduced uncertainty but is instead subject to significant variation over the life of the asset dependent upon the state of the asset and the associated required maintenance. As previously mentioned, this could be subject to manipulation.

b. The essence of the argument here is that the GRV ceiling is uncertain and the DORC ceiling would be subject to much less uncertainty. But in terms of the annual capital cost element in the same way that the GRV was attached to the gross replacement value of the assets and that this is subject to increases in value, exactly the same applies to the RAB that underlies the DORC method which is subject to asset appreciation. So, there is no real difference in variability of the capital element and the operating element would actually be subject to more uncertainty under DORC than under GRV.

4. *Presents better investment incentives by including actual expansion costs in cost determinations (including efficient project management costs).*
    a. This is exactly the same argument as was listed as a cost of the GRV methodology now listed as a benefit of DORC in 4. above. The same responses above - 4.a. and b. apply.

5. *Where access negotiations fail to achieve an outcome, the floor and ceiling prices provide more useful guidance to the arbitrator, as they reflect the condition of the asset*.
    a. This is only true under circumstances where the DORC method more closely aligns with the value of the asset - which simply doesn't apply in the case of the Pilbara railways.

6. *Offers consistency with other rail access regimes and extensive regulatory precedent to guide the application of the methodology*.
    a. The fact that the valuation methodology aligns with other rail access regimes is not a benefit to railway owners if the result is, as seems likely, that compliance costs will increase; and there is no benefit for access seekers from consistency as they don't bear any regulatory compliance costs.
    b. There is no reason to have consistency with other rail access regimes for railways, like those operating in the Pilbara, that don't and cannot interact with other railways and their regimes.
    c. The Draft Decision Paper contains unsubstantiated assertions that DORC has been assessed as the "*most reasonable*" valuation methodology by other rail access regimes and therefore by implication (and for consistency with the best) the same should be adopted in WA. The justification for this claim was the IPART Report (see footnote 2 of the Draft Paper):
        i. The following is a quote directly from that document:
        "*IPART is generally of the view that DORC is **not** the 'most reasonable' valuation methodology for setting a maximum allowable revenue of a utility*".
        ii. The IPART Report actually expressed the view that the most reasonable asset valuation methodology for the ceiling tests under the access regime was either indexed depreciated actual cost **or** DORC.
        iii. It is important to consider the context of the IPART Report since the asset valuation methodology was determined as appropriate for application to the Rail Access Corporation (RAC), an organisation that was established to manage and provide access to the track in NSW, and contained a

caveat that it was not necessarily appropriate to a declared monopoly service (which is effectively what the Pilbara railways are).

iv. It was undertaken in the context that the existing valuation methodology (discounted replacement cost – where the discount was used as a proxy for track condition) gave rise to a far lower valuation; and that as a result of moving to DORC the value of the assets increased.

v. There was no objection to moving to DORC by many of RAC's customers because they already gained access at prices well below the ceiling and therefore a move to increase ceiling was of little concern to them since it wasn't expected to alter the access price.

d. The Draft Decision Paper also alludes to the idea that the Productivity Commission had suggested that the NCC should encourage an approach that facilitated greater consistency across jurisdictions (see footnote 3 of the Draft Paper)

i. However, this recommendation came with the premise that there was a similarity of purpose for which the asset valuations were sought – but that similarity of purpose does not apply in relation to the railways in the Pilbara.

7. *A regulatory valuation of the asset will not have to be completed when an access proposal is made, which will expedite the process for an access application to be dealt with*.

a. Not having to undertake a regulatory valuation when an access proposal is made is a function of the fact that under DORC an up to date estimate of the asset value has to be maintained every year – in effect instead of waiting until an access seeker materialises, the asset value is updated every year even if there are no access seekers and no prospect of any access seekers.

b. If a GRV valuation has previously been made, the length of time it would take update it is not going to make a material difference to the length of negotiations (at least for Pilbara railways) because the most time-consuming aspect of rail access negotiations is in determining the associated terms and conditions. Negotiations could easily commence with the old GRV value in place until the new value had been calculated. The value only determines the ceiling.

c. Under DORC there is still a requirement to develop a forecast RAB for each year of the access proposal at the time an access proposal is made, so that it could be used as an input into assessing the incremental and total costs; so the alleged expediting of an access proposal is largely illusionary as there will not be a significant difference in the time required to develop up to date access information to underpin negotiations.

The entire analysis in the Draft Decision Paper is framed in terms which accept the premise that depreciation should be allowed to reduce assets values over time and therefore the revenue allowed to be earned from those assets. Such a concept may be relevant where a publicly owned railway, which has considerable surplus capacity has been transferred to control by a private entity and the regulations are designed to ensure that the new operator doesn't exploit its monopoly position to earn above normal profits from its control over access. The situation is entirely different for the railways of the Pilbara which signed up for allowing their railways to be put under the *Railways (Access) Act 1998* (Act) as part of the conditions of being allowed to build

the railways. The Act clearly involved only light touch regulation and was written in a manner that ensured that access to what were privately funded railways built for the purpose of transporting iron ore from inland Pilbara to port facilities on the coast would only be made available to third parties on the condition that there was surplus capacity on the railways to make available and that without such access being made available there would be entirely wasteful duplication of infrastructure (because the access seeker would be forced to build a new and unnecessary railway). There was never any intention or understanding at the time when TPI agreed to put its railway under the Act that the terms might be altered so as to create an ability for access seekers to lower the cost of developing their projects (that produce products that compete with TPI's parent company, Fortescue Metals Group), by forcing access to the railway on terms that would be substantially lower than building a new railway would cost. TPI agreed to the railway coming under the Code to avoid wasteful duplication of infrastructure; it did not agree to come under a Code that would effectively subsidise its competitors.

However, Fortescue's main objection to 'Recommendation 1A' is not that it will lower the ceiling price and create subsidised access to whatever surplus capacity there may be on the railway line – it is that it will involve significant additional compliance costs during the transition, it will also involve not insignificant ongoing compliance costs (including those incurred by the ERA which will be back charged to the railway owners) in order to assist access seekers that don't currently exist, and are unlikely to materialise in substantial numbers, if at all, to gain access to something that also doesn't currently exist – and that is surplus capacity on the railway line. Moreover, even if there were surplus capacity on the railway line, access seekers also need port capacity to take their product to and that also doesn't exist.

Draft Recommendation 1A should be amended so that the change in the asset valuation methodology to a building block approach based on an initial DORC valuation (with proposed floor and ceiling prices aligned to it) should only be applied to railways where there would be proven to be a benefit from adopting such an approach. In particular, it should not be applied to the railways of the Pilbara.

3.2 Recommendation 1B

Allow for flexibility in the assessment of historical depreciation to manage transitional impacts on existing railway owners.

The need to allow for flexibility in the assessment of historical depreciation so that an annuity approach could be adopted to manage transitional impacts on existing railway owners, at least for a limited time, is a recommendation only required if the DORC approach is adopted.

Fortescue strongly believes that it is inappropriate to apply the DORC methodology to the railways of the Pilbara.

Draft Recommendation 1B is reasonable under circumstances where the DORC approach is being used. For reasons already described the DORC approach should not be applied to the railways of the Pilbara – in which case Recommendation 1B is not required for those railways.

3.3 Recommendation 2

Require railway owners to publish a standing offer for defined rail tasks when required by the ERA.

It is entirely unclear what criteria the ERA would use to determine whether or not a railway owner would be required to publish a standing offer. The Department suggested the following factors would be relevant

1. There are one or more actual or potential operators on a route.
    - 'One or more' has the same meaning as 'any'
    - There is no guidance concerning what constitutes a 'potential' operator.
    - Any route that exists could be said to have a potential operator.
    - So, this criterion just means any route that exists.
2. The one or more entities on a route should have similar freight tasks
    - It isn't clear how one entity on a route can have a similar freight task.
    - Freight tasks were defined in terms of
        i. Train length
        ii. Axle load
        iii. Freight type

It is not clear in the context of the Pilbara railways why these three factors would determine similarity of freight task:

- Train length is largely immaterial except for the fact that any train operating on the system must be short enough to use the passing sidings. That is a technical requirement and cannot be said to determine similarity of freight task since all rolling stock must comply.
- Axle load is largely immaterial except for what is again a technical constraint of not allowing an axle loading above the design limit of the track. All freight necessarily has to be below the limit, or it will cause excessive damage to the track. This is not a factor that determines similarity of freight task.
- Freight type – it is not clear what is meant by freight type, but the railways of the Pilbara are heavy haul railways designed to transport heavy bulk products. But any product that can be loaded into a bulk wagon can be transported on the railway and the terms of access are not normally such that there is a need to differentiate between different products (since they don't interact with the rail infrastructure).

If a railway owner has surplus capacity and is seeking new customers to increase its revenue and spread costs, it is perfectly able to publish a standing offer that gives an indication of the price for access and the necessary associated terms and conditions. If a railway owner is operating the railway at capacity and effectively utilising a run when ready scheduling to extract greater capacity from the track than could be expected from the same track operating under a predetermined schedule – there is no meaningful standing offer that could be published because access is only possible under terms dictated by a flexible scheduling arrangement under which price and flexibility are interrelated.

Given the criteria described to determine similarity of freight tasks it would appear that the Pilbara railways would be asked to publish standing offers for defined tasks. Yet without having negotiated the necessary flexibility in scheduling all that could be published would be a standing offer that imposed impossible flexibility requirements on access seekers and would demand the maximum possible price (the ceiling) for the associated risk and inconvenience. Far from encouraging access seekers it would send the converse message.

Draft Recommendation 2 should be altered so that railway owners would be required to publish standing offers that best reflected the additional customers they would like to see accessing their railway or parts of it and under terms and conditions that were associated with it.

3.4 Recommendation 3

Introduce a competitive imputation pricing principle as a part of the pricing principles set out in Clause 13, Schedule 4 of the Code.

The pricing principles set out in Clause 13 of Schedule 4 of the Code states that:

> "*In the negotiation of prices for the provision of access, the railway owner is to implement the following guidelines - ….*
> *(c) prices should reflect as far as is reasonably practicable - ….*
> *(ii) the relevant market conditions;* "

Relevant market conditions related to pricing would normally include consideration of the pricing of products that were close substitutes. In other words, relevant market conditions to the pricing of rail access already covers consideration of alternative modes of transport (such as road haulage) if they are considered close substitutes able to provide a similar quality of product.

Draft Recommendation 3 is unnecessary as competitive imputation pricing is already covered under the requirement in clause 13(c)(iii) to consider relevant market conditions.

3.5 Recommendation 4

Extend the requirement in s.16(1)(b) of the Code to not unfairly discriminate between proponents to access agreements made outside the Code.

Section 16(1)(b) of the Code requires that a railway owner when negotiating access agreements must not unfairly discriminate between one proponent and another. Since 'proponent' is defined under the Code as an entity that has made a proposal for access under the Code – this means that the restriction on unfair discrimination does not extend to any negotiations that are made outside the Code (and that might be better than what is offered when under the Code).

What is proposed is that an arbitrator should be able to use its powers under the *Commercial Arbitration Act 2012* to collect information to assess whether unfair discrimination is being applied if requested by a proponent seeking access.

While the recommendation seems eminently sensible, it is based upon the premise that an access seeker would know whether or not unfair discrimination was present and would only request an arbitrator to undertake such an investigation if there were solids grounds for suspecting that unfair discrimination was present. The reality is likely to be different, if the stage has been reached where arbitration has started then clearly commercial negotiations have failed and if there are already other users on the railway then the access seeker is almost bound to allege that their terms of access must have been better and therefore discrimination is involved.

It is important to ensure that what are in effect ambit claims are not allowed to progress to the point where leverage becomes possible because of the impost of having an arbitrator crawling over other agreements looking for details to cherry-pick in support the proposed access seeker.

Draft Recommendation 4 is supported subject to Recommendation 7 being strengthened to ensure that ambit claims are also included as matters that can be referred to the arbitrator for weeding out prior to engaging in expensive negotiations.

3.6 Recommendation 5

Allow access seekers who have begun negotiations outside the Code to fast-track the process to arbitration under the Code.

There is merit in amending the Code so as to enable parties that have negotiated outside the Code but been unable to reach a commercial agreement to then be able to bring the unresolved issues into arbitration without having to go through the full process. However, this should not be a mechanism to avoid the scrutiny that is applied to access applications under the Code. This was recognised in the Draft Decision Paper by the requirement to demonstrate that the access seeker had been able to comply with section 14 requirements {managerial and financial ability}. There also needs to have been a demonstration the proposed operations are within the capacity of the route or expanded route {section 15 requirements}.

The proposal that an access seeker seeks to take to arbitration must also be confined to being the same proposal that had been the subject of the commercial negotiations that were not resolved.

Draft Recommendation 5 is supported subject to the requirements of both sections 14 and 15 having been satisfied and that the proposal to be taken to arbitration has not changed from what was proposed when the requirements were satisfied or changed from what was discussed under commercial negotiations.

3.7 Recommendation 6a

Make both parties responsible for assessing whether an expansion is required to facilitate an access request when a proposal for access is made.

It is proposed that section 9 of the Code would be amended to require the railway owner to notify the access seeker if they believed that an expansion would be required and to provide a preliminary estimate of the associated costs and the share that would be borne by the access seeker.

This will involve the railway owner incurring costs in assessing whether such an expansion is required. The Draft Decision Paper plays down these costs on the basis that the railway owner would be likely to incur these costs anyway as part of informing themselves to assist in their negotiating position and that they would be able to recover the efficient costs of complying with this new obligation.

However, there is a matter of timing involved here. The railway owner should not be put to the cost of costing the expansions required to meet an access seeker's demands before the access seeker has established its bona fides. That is to say the railway owner should not be required to incur costs before the access seeker has demonstrated that it can meet the requirements of sections 14 and 15 or before the railway owner has been given the opportunity to decline to deal with an access application on the grounds that it is frivolous or represents nothing more than an ambit claim.

The fact that a railway owner would be likely to undertake a costing of any expansion in order to inform its negotiating position doesn't negate the fact that it is a cost that is incurred as a result of an access proposal that it wouldn't ordinarily otherwise incur. Moreover, the notion that the efficient costs are recoverable is premised upon the access seeker actually gaining access and being available to 'recover costs from'; that will not always be the case.

Draft Recommendation 6a is supported subject to the railway owners not being required to incur the associated costs prior the access seeker having met the requirements of sections 14 and 15 and Recommendation 7 having been implemented with ambit claims included along with frivolous ones.

3.8 Recommendation 6b

Place responsibility on the railway owner for demonstrating if an extension or expansion is technically feasible.

Draft Recommendation 6b is supported subject to the same caveat that applied to Recommendation 6a.

3.9 Recommendation 6c

Remove requirement to demonstrate technical feasibility as a pre-requisite to beginning negotiations and clarify that a request for an extension or expansion can be made at any time during negotiations if necessary to facilitate the access request.

Draft Recommendation 6c is supported subject to the caveat that if it becomes apparent during negotiations that an extension or expansion is required then the obligation to show financial ability under section 14 would need to be tested under the new financial requirements that would be associated with the expansion or extension.

3.10 Recommendation 7

Insert a provision to allow a railway owner to refer an access request to the arbitrator if they can establish a prima facie case that it is frivolous.

The Draft Decision Paper discusses 'frivolous access requests' as if there were a clear meaning to the term in this context. In addition, it was noted that other rail access regimes allow access requests to be referred to an arbitrator if they believe the request is frivolous or vexatious.

It seems unlikely that access seekers that meet the requirements of section 14, namely having the knowledge and experience to carry out rail operations would submit an access proposal that was frivolous – and if it was frivolous that would be evidence of a lack of the necessary knowledge and experience required to run a railway. Of much more concern to railway owners is that an access seeker may be behaving in a manner that is vexatious or constitutes nothing more than an attempt to force the railway owner into agreeing to unfavourable commercial terms in order to avoid dealing with an 'access application that is designed to cause problems for the railway owner' or is, in some other way, an ambit claim for access.

Draft Recommendation 7 is supported subject to the railway owner being able to refer not merely frivolous, but also vexatious applications and any application that can be demonstrated to represent commercially unrealistic proposals or to be any form of ambit claim.

3.11 Recommendation 8

Insert timeframes for obligations under the Code where these do not already exist.

Draft Recommendation 8 is supported.

3.12 Recommendation 9A

Require the ERA to approve a standard access agreement for each railway owner and for this agreement, along with other relevant information to be published on a railway owner's website, instead of in hard copy format.

The Draft Decision Paper is inconsistent over the issue of whether any standard access agreement requires the approval of the ERA or not. In the section describing how Draft Recommendation 2 would be implemented it states "The *railway owner would be required to develop standard terms and conditions to underpin the standing offer, including service standards associated with that price. This would also* ***not need to be approved by the regulator***". Here it is being suggested that Part 2A of the Code would be amended to require each railway owner to have at least one standard access agreement approved by the regulator.

The same issue arises here as was encountered in Recommendation 2, namely that any access seeker to the railways of the Pilbara is going to have to negotiate flexible terms and conditions that are entirely unique to the way that their proposed operations will need to interact with existing operations. There is no standard access agreement that is relevant and having the ERA attempt to determine what would be a suitable standard access agreement is beyond their possible knowledge base (because nobody knows in advance what an access seeker's requirements in relation to flexibility will be). The most likely outcome will be that owners of the Pilbara railways will simply revert to standard terms and conditions that involve no flexibility and effectively impose a schedule on all users of the railway. This in turn would significantly reduce the capacity of the rail system which would remove the surplus capacity that an access seeker might have been able to access.

Draft Recommendation 9A should only be applied to railways where operations are undertaken on a scheduled basis. If applied to the 'run when ready' scheduling of the Pilbara railways it will have the unintended consequence of removing any surplus capacity that might be available to access seekers from the railways.

3.13 Recommendation 9B

Implement Recommendation 8 from the 2015 ERA review, to reduce the prescribed time limit for updating this information from two years to one year.

The requirement for a railway owner to keep published information up to date is set out in section 7C of the Code. The information is required to be updated as often as is necessary to ensure that the information remains reasonably up-to date at all times – section 7C(2)(a). Section 7C(2)(b) is a backstop that requires that if it hasn't been done for a two-year period then it should be updated anyway.

When this was proposed in the ERA's 2015 review TPI objected to the entirely unnecessary burden of being required to review the information and update more frequently that every two years. The Authority responded by agreeing that Schedule 2 information for TPI's railway may not require review as often as for general freight railways but noted that a section 7C(2) requires only a review, and an amendment or replacement if necessary. This interpretation of the Code is

entirely incorrect. Section 7C(2) requires a review to be undertaken every two years regardless of whether it is necessary or not. The 'if necessary' applies to the undertaking of any amendment or replacement once the review has been undertaken. It is the review that takes resources, the subsequent amendment or replacement of information that is published is trivial in that respect.

Draft Recommendation 9B places an entirely unnecessary regulatory burden of the owners of the railways of the Pilbara and its application should be restricted to general freight railways where there may be such a requirement.

3.14 Recommendation 10

Standardise section 8 and 14 requirements.

Draft Recommendation 10 is supported

3.15 Recommendation 11

Standardise consultation across Part 5 instruments.

Draft Recommendation 11 is supported

3.16 Recommendation 12

Require the ERA to develop and maintain a model set of Part 5 instruments.

If the ERA is required to maintain a model set of part 5 instruments this will impose additional costs on the ERA as was acknowledged in Table 23 of the Draft Decision Report. The benefits that by implication outweigh these costs are alleged to be that there will be more timely access to new railways. With regard to new railways of the type that operate in the Pilbara (i.e. heavy haul railways) the commissioning process and gradual ramp up of capacity after initial construction has been completed takes longer than 6 months and during this process it would be unreasonable to expect the new railway owner to negotiate access terms to a railway whose operating parameters had not been established.

It would seem highly unlikely that any new railway would be built in Western Australia other than in the Pilbara. So, in effect there is no benefit from bringing forward access to the only new railways likely to be built because they are not ready to accommodate access seekers during their initial phase. This proposal will result in any increase in regulatory burden on the ERA that will back charged to railway owners for no benefit.

Draft Recommendation 12 is not supported because it will increase regulatory burden with no offsetting benefit.

3.17 Recommendation 13

Provide for an arbitrator to make an interim order on access prices, terms and conditions if parties have an agreement under the Code that is expiring and are renegotiating under the Code.

Draft Recommendation 13 is supported.

3.18 Recommendation 14

Include requirements to publish service quality indicators.

To the extent that there are relevant service quality indicators for a railway being operated under a 'run when ready' scheduling regime, their publication would make available commercially sensitive information to competitors not covered under the regime and therefore not required to publish the same information.

Draft Recommendation 14 should be modified to exclude the requirement to publish service quality indicators where that information is commercially sensitive and where competitors are not under the same obligation and therefore the publication would be competitively disadvantageous to the railway operators required to do it.

3.19 Recommendation 15

Improve up front guidance for the regulator and require additional expert advice to inform decision making where appropriate.

The proposal is that where there are valuation differences, between the railway owners and an 'expert', the ERA should be able to use a second 'expert' to resolve the differences.

Whilst in theory the idea of using additional expert advice to inform the initial regulatory asset valuation is sound – in practice that depends upon the quality and impartiality of the expert advice obtained. Fortescue would point to the many problems it has identified in the Synergies Report to highlight the inadequacy of both the quality and indeed impartiality of expert advice in an area where little exists.

Draft Recommendation 15 is only supported on the condition that the railway owners agree that the 'expert' giving advice on any difference between the railway owner's valuation and the first expert opinion is acceptable in terms of quality and impartiality.

3.20 Recommendation 16

Amend the Code to explicitly allow for differential treatment of foundation customers as a form of 'fair' discrimination.

Draft Recommendation 16 is supported.

Fortescue would be happy to explain all or any of these points in more detail should there be such a requirement.

Yours sincerely

FORTESCUE METALS GROUP

TIM LANGMEAD

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